I
n all the recent gloomy news about pension funds shortfalls, there has been precious little mention of the pension fund that affects most Canadians—and for good reason. The Canada Pension Plan’s investment fund has taken a hit, just like every other fund in the world, but even so, the CPP will be ready to make good on all its promised pensions and other benefits for decades to come.

Let’s get one point out of the way quickly. No, the CPP is not fully funded, the safety marker for employer pension plans everywhere, but anyone who thinks this matters is missing the point. National pension plans are properly measured by different criteria, one of which stands out. An employer can go bankrupt, cutting off any chance of receiving a shakey pension plan to a sound footing through future contributions from the employer and its workers alike; the plan is orphaned, and the beneficiaries are left to bear the consequences. Countries don’t go bankrupt, so Canadian companies—the vast majority of which will survive any economic setback—and their workers will continue to contribute to the CPP. Besides, the CPP is on such a solid long-term path that it will need very little of the fund’s accumulated savings to see it through the inevitable years when benefits for the baby boomers exceed contributions from the much smaller generations that follow.

Today, the CPP fund, managed by the CPP Investment Board, looks very much like the other major funds that manage big pools of public money—the Ontario Teachers’ Pension Plan Board, the Ontario Municipal Employees Retirement System, the British Columbia Investment Management Corp., and the Alberta Investment Management Corp. The CPP fund is a behemoth, the largest public pension fund in the world, but even so, the CPP will be ready for good reason. The Canada Pension Plan’s investment fund was introduced for OAS.

There were two reasons why the CPP was introduced for OAS. First, pensions fell under provincial jurisdiction. The government had needed a constitutional amendment in 1951 to introduce the Old Age Security program and it would need another amendment to launch the CPP, which would include “non-aged” benefits for disability and survivors. The battle over the CPP pitted Ottawa mainly against both Quebec and Ontario in one of the most dramatic episodes in federal-provincial relations. Most provinces found Quebec’s plan to invest pension surpluses highly appealing, so when Quebec went its own parallel way with the Quebec Pension Plan, the other provinces demanded the same thing from the new CPP as a price for their support. This was not just easy money for the provincial treasuries. The baby-boom generation had already flooded into the primary and secondary schools and was now hitting the rapidly expanding universities and new community colleges. Provinces wanted the money to invest in the infrastructure needed by a growing and increasingly prosperous country. This was not mere government spending; it was nation building.

From the CPP’s inception in 1966 through the early 1990s, the fund grew steadily to a peak of just over $42 billion. In 1993, however, it began to shrink, mainly because Ottawa and the provinces had consistently shied away from the tough decisions needed to keep the CPP sustainable. The designers of the CPP knew that the initial contribution rate of 3.3% of covered earnings would not cover the long-term costs, but counted on their successors to make the proper adjustments. Instead, governments of the 1970s and early 1980s left the contribution rate unchanged while increasing benefits. Beginning in 1987, they finally brought in a system of annual rate increases, but undermined any revenue gains with yet more benefit enhancements. In 1992, they put the scheduled contribution rate increases on an even steeper ramp, this time combined with very modest new benefits, which reflected the growing concerns over government finances in general.

By 1995, the fund was still contracting, a consequence of both a steep increase in disability benefits and the recession of 1990-91, followed by an achingly slow recovery. Ottawa and the provinces were also facing a report from the CPP’s Chief Actuary that said the fund would be exhausted by 2014 if governments did not act to restore the CPP’s financial health. The report was a bombshell. In the shaky economic environment of the early 1990s, Canadians were already growing worried about the state of the CPP, just as they were rebelling against big government deficits. Newspapers and magazines had prominently featured articles that underlined those fears. A March 1992 Maclean’s magazine article carried the ominous heading: “Are Pensions Safe? Why Canadians cannot count on government to secure a golden retirement.” Young people appeared to have written off their chance of ever seeing a pension from the CPP. Worse, they had little faith that governments had the will to correct the problem.

The timing of the Chief Actuary’s report—just three days before Finance Minister Paul Martin’s seminal 1995 budget that put federal finances firmly on the path to surpluses—could not have been better. Under the rules adopted a decade earlier, the doomsday actuarial report was the starting gun for the next review of the CPP. This time, policymakers were ready for something more than another raise-rates-and-call-me-in-five-years solution. The officials, many of whom had

Canada Pension Plan Through History

1966 - The CPP and QPP came into force on January 1, 1966.
1967 - The Guaranteed Income Supplement was established as part of the Old Age Security program.
1972 - Full annual cost-of-living indexation was introduced for OAS
1973 - Quarterly indexation was introduced for the Old Age Security program.
1974 - Full annual cost-of-living indexation was introduced for the CPP.
1975 - The Spouse’s Allowance was established as part of the Old Age Security program.
1975 - The same Canada Pension Plan benefits became available to male and female contributors, as well as to their surviving spouses or common-law partners and dependent children.
1977 - The payment of partial Old Age Security pensions was permitted, based on years of residence in Canada.
1978 - Periods of zero or low earnings while caring for the contributor’s child under the age of seven were excluded from the calculation of Canada Pension Plan benefits.
1978 - Canada Pension Plan pension credits could be split between spouses in the event of a marriage breakdown (CPP credit splitting).
toiled in the CPP vineyard for years, were weary of imperfect fixes. Their finance ministers, most of whom were bent on eliminating their fiscal deficits and the resulting rise in government debt, brought the same mindset to the CPP and the burden it was putting on future generations. They knew that if they did nothing, the CPP’s default provision, also agreed to a decade earlier, would send the contribution rate soaring to more than 14% from its then current 5.6% level.

THE BIG FIX
Their solution was simple, even elegant. The contribution rate would rise even more quickly than currently scheduled, but permanently capped once it reached 9.9% of earnings. Benefits would be reduced for future recipients—no politician dared touch existing benefits to seniors—but the cuts would be phased in so gradually that few would notice. Those changes, by generating higher revenues but more slowly growing expenditures, would produce annual surpluses that would reverse the decline in the CPP fund. It was called steady state financing—a middle ground between the existing pay-as-you-go system and full funding. The CPP had to meet the unfunded commitments made to plan members over the previous three decades. The higher contribution rate and the investment income from the bigger CPP fund would ensure that there was enough revenue to cover all future costs, even when the baby-boom generation was fully retired. That unfunded liability was clearly a burden—it accounted for fully 3.8 percentage points of the 9.9% contribution rate, but it meant the burden would be shared equally across generations. The boomers would begin paying a much bigger share of their own future pensions; the young would not face the prospect of those 14-plus per cent contributions that would have left them financing both their parents’ pensions and their own.

Now came the biggest innovation of the planned reform. The new money in the fund would no longer be loaned to the provinces, but invested in a wide range of financial instruments—stocks, bonds and other investments that would earn a higher rate of return than loans to the provinces. The idea of concentrating that much money in the hands of government had been rejected in the 1960s when it was vigorously opposed by the insurance industry, which was none too keen on the idea of public pensions, period. But by the 1990s, Canadians were familiar with large public pension funds that earned better returns than the CPP. Even so, many still feared that such a large fund, which would quickly become one of the largest in the country, might be abused by governments. After a quarter century of deficits and rising debt—both federally and in all provinces—governments didn’t exactly have a strong record of money management.

The idea of using big pension funds as a model for the CPP had first been raised publicly in 1993, when the Metropolitan Toronto Board of Trade urged Ottawa to “speed up the increases in contribution rates for the next 10 or 15 years to put more money in the CPP kitty and then invest the money the way a private pension plan would.” In 1995, as Ottawa and the provinces began looking at their options, the idea gained traction. Pension consultant Keith Ambachtsheer, in an advisory letter to clients, said Canadians would accept higher CPP contribution rates only if there was “a credible mechanism to turn excess CPP contributions into productive investments.” That was possible because Canadians had already “learned how to create legitimate arm’s-length pension investment agencies,” like Teachers’.

1987 - Several new CPP provisions came into effect, including:
• flexible retirement benefits payable as early as the age of 60;
• increased disability benefits;
• continuation of survivor benefits if the survivor remarries;
• sharing of retirement pensions between spouses or common-law partners;
• expansion of credit splitting to cover the separation of married or common-law partners.

1991 - Legislation was passed to assist those people who were denied CPP credit splitting as a result of a spousal agreement entered into prior to June 4, 1986.

1992 - Three major amendments to the CPP came into effect:
• A new 25-year schedule for employer-employee contribution rates was established.
• Children’s benefits were increased.
• Provision was made for individuals who were denied disability benefits because of late application.

1998 - The CPP moved from pay-as-you-go financing to fuller funding.
• Contribution rates were increased. A new investment policy was introduced.

2000 - All OAS and CPP benefits and obligations were extended to same-sex, common-law couples.

Source: Human Resources Development Canada, www.civilization.ca
Ottawa and the provinces were listening. In early 1996, as a precursor to cross-country public consultations, they released an information paper that sketched out a new investment policy along just these lines. The CPP could invest “most or all” new funds in the market. “Increasingly, pension plans in Canada sponsored by governments as employers have their assets professionally managed and invested in the interest of pension plan contributors and beneficiaries. … Pension funds managed on the basis of this principle are generally invested in a diversified portfolio of assets which enhances returns and prudently limits risks.” This appealed to Canadians. A June 1996 report on the public hearings concluded, “There was near unanimous support … for a better investment strategy for the CPP fund,” and “wide agreement that the fund should be carefully managed at arm’s length from government under a fiduciary mandate.” If the provinces were to keep their priority access to the fund, “there was a strong consensus that they should pay market rates.”

That was enough for politicians to give the new investment policy a green light. They left the job of sorting out the details to a federal-provincial working group of officials. It took another eight months, until February 1997, to reach a deal on the wider package of CPP reforms, but it was other issues—not the new investment policy—that divided governments during this period. Along the way to the final agreement, the finance ministers endorsed a set of principles for CPP, including one saying the fund would be invested “in the best interests of plan members,” meaning there would be no secondary investment objectives like economic or regional development, and the fund managers, operating under sound governance structures, would “maintain a proper balance between returns and investment risk.”

The February deal, as well as raising contribution rates and cutting future benefits, provided that the larger CPP fund would be “prudently invested in a diversified portfolio of securities in the best interest of contributors and beneficiaries,” a policy “consistent with the investment policies of most other pension plans in Canada and the QPP.” The ministers figured the new investment policy could earn a return of 3.8% above the rate of inflation. The money would be “managed professionally at arm’s length from governments” by a new CPP Investment Board (CPPIB) run by “a qualified board of directors.” The governments were not yet ready to jump into the business of picking stocks. For the first three years, the CPPIB would have to select its domestic equity “passively, mirroring broad market indexes.” Provinces could roll over their existing borrowings from the fund at least once, but would pay their own market rates for the loans; aside from that transitional provision, the old investment policy was dead.

**ARM’S LENGTH**

The policymakers took great care to ensure that the CPPIB would be as far removed from government influence as possible. “We pushed for the most arm’s-length model we could find,” one official recalled later. They began with the rules governing the Bank of Canada, which operates with almost complete independence from the government, and then went further: “In every area we could think of, we put more distance between the government and the CPPIB.” The CPPIB would be a federal Crown corporation, but its board of directors would appoint the chief executive officer, with no right of veto for Ottawa; it would not even be subject to federal hiring guidelines for such positions. The directors even got to choose the location of the CPPIB’s head office. Officially, Ottawa appointed the directors, but could do so only from a list of names submitted by a joint federal-provincial nominating committee and only after consulting with the provincial governments.

It took the rest of 1997 to get the necessary legislation through Parliament and most of 1998 to write the detailed regulations and appoint the CPPIB’s first directors. The first transfer of funds—$12.1 million—arrived in the CPPIB’s bank account in March 1999, a tiny fraction of today’s sum. CPP assets peaked at almost $128 billion last June, but then fell to just over $117 billion in September and almost certainly fell further in the final three months of 2008. Such losses are never nice will do nothing to undermine the CPP’s ability to pay all benefits, at least as far as the actuarial eye can see.

The CPP remains, and will remain, largely a pay-as-you-go plan and Canadian employers and workers will continue to cover most of the costs of the CPP. About a decade from now, the day will arrive when contribution revenues will not fully cover expenditures on pensions and other benefits, so the administrators of the CPP will have to turn to the CPPIB for the money to fill the gap. But according to the Chief Actuary’s latest full 75-year projection, the annual draw will never amount to more than about 2% of the fund itself. Even if—as now seems all too certain—the fund will not grow as quickly as the Chief Actuary projected in 2007, that’s a big cushion for future pensioners to rest their heads on.

The reformers of 1997 did not anticipate the kind of financial market meltdown we have witnessed in recent months. But the reforms they crafted rebuilt the CPP into a vehicle robust enough to weather even this kind of setback.